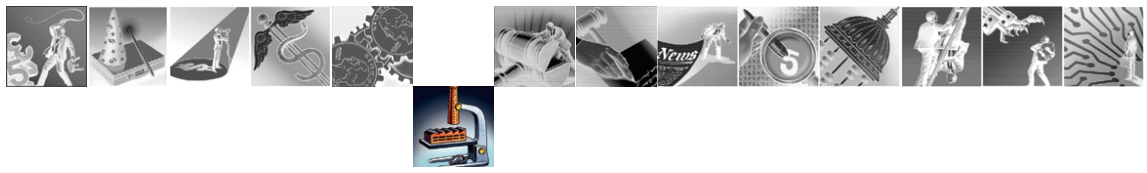

NOT EXACTLY. BUT HOW MUCH MASTERCARD IS WORTH IN ITS IPO DEPENDS ON HOW IT FRAMES ITS GROWTH STORY

PRICELESS?

MasterCard Inc.'s initial public offering will be the largest in payment networks services ever. What's MasterCard worth? Its value depends on the market's perception of management's ability to accelerate the global payment network's growth and to mitigate worldwide regulatory risk, legal liability overhang in the U.S., constraints of continued bank oversight in Europe and its association culture.

MasterCard is a unique global franchise with immense upside. Its larger cousin Visa is split into several increasingly separate organizations, most of which will remain bank membership associations for the foreseeable future. An independent MasterCard will be freer and have more tools with which to aggressively pursue growth.

The market must, however, discount the valuation for several factors.

Regulatory risk is significant. While post-IPO it will no longer be able to be plausibly argued MasterCard is a bank consortium fixing prices and restraining competition, which is the rationale for much regulation, regulators will not stop treating the payment network as a public utility. Governments outside the U.S. have been increasingly interventionist in regulating MasterCard's interchange system, which balances the interests of the issuing and acquiring sides of the network. Typically the merchant's acquiring bank pays the card-issuing bank a percentage of each transaction, through MasterCard. Interchange provides incentive to financial institutions to issue more cards and fuels benefits rewarding cardholders, both of which create network value.

Post-IPO, banks will no longer control MasterCard in the U.S. Nevertheless, legal liability overhang will remain. There are 38 outstanding federal suits concerning interchange and no-surcharge rules. (Generally, the interchange suits argue merchants have been harmed by a tax—interchange—imposed on them by a bank conspiracy; many of the no-surcharge suits contend MasterCard's ban on merchant surcharges results in supracompetitive merchant discount rates.)

In Europe a banker board will continue to oversee MasterCard. This may hinder the payment network's ability to develop nonbank sectors in its second-largest market and give governments a continuing rationale to regulate, tamping down the franchise's value.

The global payment network's association culture will not magically overnight be transformed into an enterprising can-do commercial culture. So, given the hurdles, can MasterCard grow faster?

Its revenue derives principally from transaction-processing fees and assessments on card volume. Opportunities abound to increase both. MasterCard does not process its own or its competitors' payment transactions in the vast majority of national markets. Additionally, most people worldwide do not use MasterCard, and of those who do, few use it for most payments.

Swimming in a current in which worldwide card transactions and volume grew 14.2% and 13.8%, respectively, during 2004, MasterCard grew its top line 16.2%. In 2003 and 2002, it grew its top line 17.9% and 17.4%, respectively. Growth in 2002 and 2003, however, was partly attributable to the June 2002 acquisition of the rest of EuroPay.

MasterCard should aggressively move to expand and deepen its processing business globally. Bank-owned networks and processors switch, clear, settle and perform risk management for domestic interbank card transactions in most major national markets. Near term this is the payment network's largest opportunity to add significant new revenue streams.

Unfettered from banks, MasterCard can develop new channels. It can cultivate relationships with mobile phone operators, retailers, insurance carriers, governments and even a **Google Inc.** to issue and acquire MasterCard products. It will also be more flexible and creative with rules and pricing.

How might the MasterCard growth story be valued? While none are exactly comparable, there are valuation guideposts in recent sales: Concord EFS, EuroPay, NYCE Corp., PayPal Inc. and Pulse EFT Association Inc.

Concord's February 2004 sale to **First Data Corp.** at 3 times revenue provides a lower valuation bound. Concord had similar revenue. Its smaller consumer-and-merchant reach, domestic-only story and narrower payment offer, which was at risk of being commoditized, suggest MasterCard should command a higher valuation multiple.

EBay Inc.'s October 2002 PayPal acquisition for 6.8 times revenue would be the upper bound. In contrast to MasterCard, the lion's share of PayPal's transactions remains in a single niche: eBay. But PayPal's growth was explosive. In the first half of 2002, PayPal's revenue grew 204% over the first half in 2001.

In 2004, MasterCard generated $2.593 billion in revenue and $238 million in net income. Presumably 2005 will be on the order of $3 billion. One can make a case for an IPO valuation from $9 billion toward $20 billion. Assuming a 10% weighted average cost of capital, a 15-year time horizon and no terminal value, increasing the payment network's growth by a couple percentage points, which is eminently doable, would add several billion dollars to enterprise value.

Unshackled, MasterCard can hit the growth throttle. How, and how compellingly, MasterCard and its investment bankers frame and tell the story will make an enormous difference to its valuation, which ought to be north of $10 billion. ■

Eric Grover is a partner at Intrepid Ventures, a consultancy based in Silicon Valley focusing on financial services, technology and processing.

#5 TOP TEN WAYS

Track Buyers Online to See Who's Hot and Who's Not.

Here's a tip that will make your next M&A deal a good deal SMARTER. Use a Virtual Deal Room to track buyer behavior and gain precious insight into every deal. The kind of insight that may mean the difference between a good deal—and a great one. To find out more, get your FREE copy of our *Top Ten Ways a Virtual Deal Room Can Help You Do Better Deals* by visiting:

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